

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate – Business Plan

ITEM NUMBER: 8

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: May 5, 1999

INFORMATION: _____

PRESENTERS: Mr. Pleis

EXECUTIVE SUMMARY

The investment real estate policy, approved by the Investment Committee in July 1998, requires the real estate portfolio to be managed in accordance with an annual business plan. The primary objective of the real estate business plan will identify how CalSTRS will address the following key issues:

- Implementation of strategic allocation to real estate over the next 3 to 5 years.
- Identification of the overall risk/return profile of the future real estate portfolio.
- Identification of the ownership structure and vehicles to be used to acquire and manage real estate at each risk level.
- Identification of the policy issues that must be modified to implement the proposed strategy.

The following chart summarizes the implementation components of this business plan:

<u>Implementation Issues</u>	<u>Low Risk Strategy</u>	<u>Moderate Risk Strategy</u>	<u>High Risk Strategy</u>
1. Allocation (as a % of the real estate portfolio) <ul style="list-style-type: none">• Current• Proposed Target• Proposed Range	73% 50% 40% to 75%	0% 25% 10% to 25%	27% 25% 10% to 25%
2. Investment Structure	Direct Only	Direct and Commingled Funds	Direct and Commingled Funds
3. Discretion to invest <ul style="list-style-type: none">• Direct Investments• Commingled Funds	Staff & manager with "Discretion in a box" Not Applicable	Staff Staff & Fiduciary	Staff through approved programs Staff & Fiduciary
4. Benchmark	NCREIF Index	NCREIF Index plus 200	NCREIF Index plus 500
5. Diversification	Geographic and property type	Limited constraints – Tactical investing	No constraints – Tactical investing

A primary component of implementing the business plan is the modification of the real estate policies. Attachment 1, Exhibit C provides a proposed real estate policy. The following chart is a summary of the proposed policy changes.

<u>Key policy changes</u>	<u>Current Real Estate Policy</u>	<u>Proposed Real Estate Policy</u>
# 3 - Portfolio Risk Composite	<ul style="list-style-type: none"> 75% low to moderate and 25% moderate to high risk 	<ul style="list-style-type: none"> 50% low risk 25% moderate risk 25% high risk
#4 - Portfolio Cash Flow	<ul style="list-style-type: none"> Low to moderate risk to meet or exceed the actuarial rate over a five-year horizon. 	<ul style="list-style-type: none"> Low risk to approximate the actuarial rate over a five-year period. Moderate and high risk will not have cash flow targets.
#8 – Diversification Guidelines	<ul style="list-style-type: none"> Direct investments will be diversified by property type and geographical location. 	<ul style="list-style-type: none"> Low risk investments will be diversified by property type and geographical location. Moderate and high risk will not have diversification constraints.
#9 – Investment Limitations	<ul style="list-style-type: none"> See Real Estate Policy #9 	<ul style="list-style-type: none"> Increased to accommodate a larger trading volume.
#10 – Discretionary Authority	<ul style="list-style-type: none"> Staff has authority to approve direct property transactions under \$100 million. CalSTRS Board must approve any transaction over \$100 million. 	<ul style="list-style-type: none"> Staff can invest in low, moderate and high risk transactions. Staff can invest in commingled funds and direct ownership under \$100 million. Staff can delegate “discretion in a box” to real estate managers for implementing the low risk strategy. CalSTRS Board must approve any transaction over \$100 million

RECOMMENDATION

Staff recommends Investment Committee approval of the 1999 Real Estate business plan and the proposed policy changes identified in Attachment 1, Exhibit C by adopting the attached resolution (Attachment 2).

California State Teachers Retirement System

1999 Business Plan

Real Estate Investments

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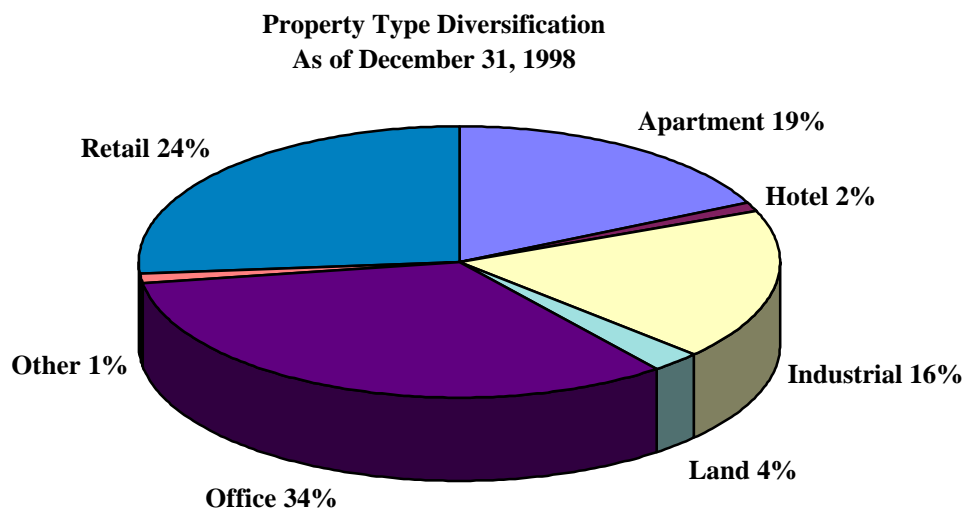
California State Teachers' Retirement System 1999 Business Plan for Real Estate Investments

Real Estate Portfolio Role

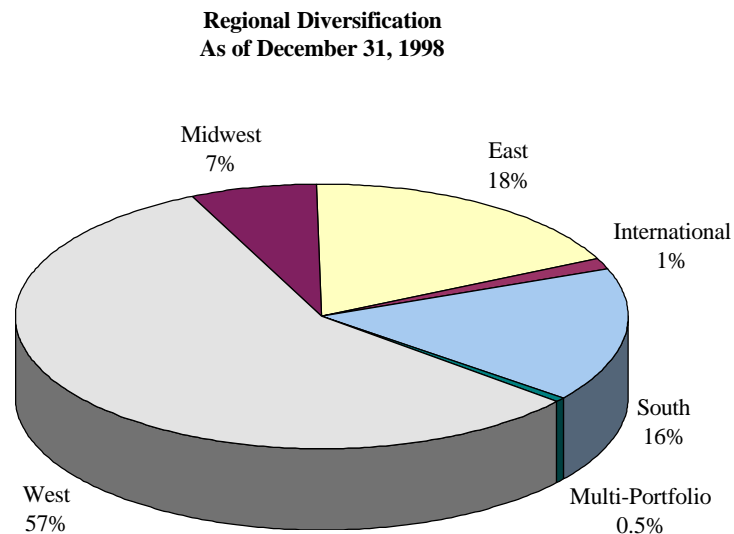
In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for investment real estate, an illiquid equity related asset, of 5% of the total assets. The primary role of investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will have an objective to achieve a rate of return that corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the overall investment portfolio. The portfolio will incorporate a combination of low, moderate, and high risk real estate investment strategies to implement the approved plan.

Current Real Estate Program

Portfolio Composition - The market value of the CalSTRS real estate portfolio as of December 31, 1998 was \$2.2 billion, which represents 2.3% of the total investment portfolio. The real estate portfolio is currently divided into two different investment structures: (1) direct ownership and (2) commingled funds (opportunity funds). Direct ownership properties, which make up 73% of the real estate portfolio, consist of office, industrial, retail and apartments. Commingled funds comprise 27% of the real estate portfolio and consist of limited partnerships investing in a wide range of property types that vary from land development to loan portfolios. The following chart identifies the various property types within the CalSTRS total real estate portfolio as of December 31, 1998.



Approximately 60% of the CalSTRS real estate portfolio is invested in office and retail property types, which corresponds to the general pension real estate market (as identified by the NCREIF Property Index). About 66% of those property types are in office and retail. The geographic diversification of the CalSTRS real estate portfolio is heavily weighted in the Western region. Approximately 57% of the CalSTRS real estate portfolio is located in the NCREIF Western region. The following chart identifies the geographic regions for the CalSTRS properties as of December 31, 1998.



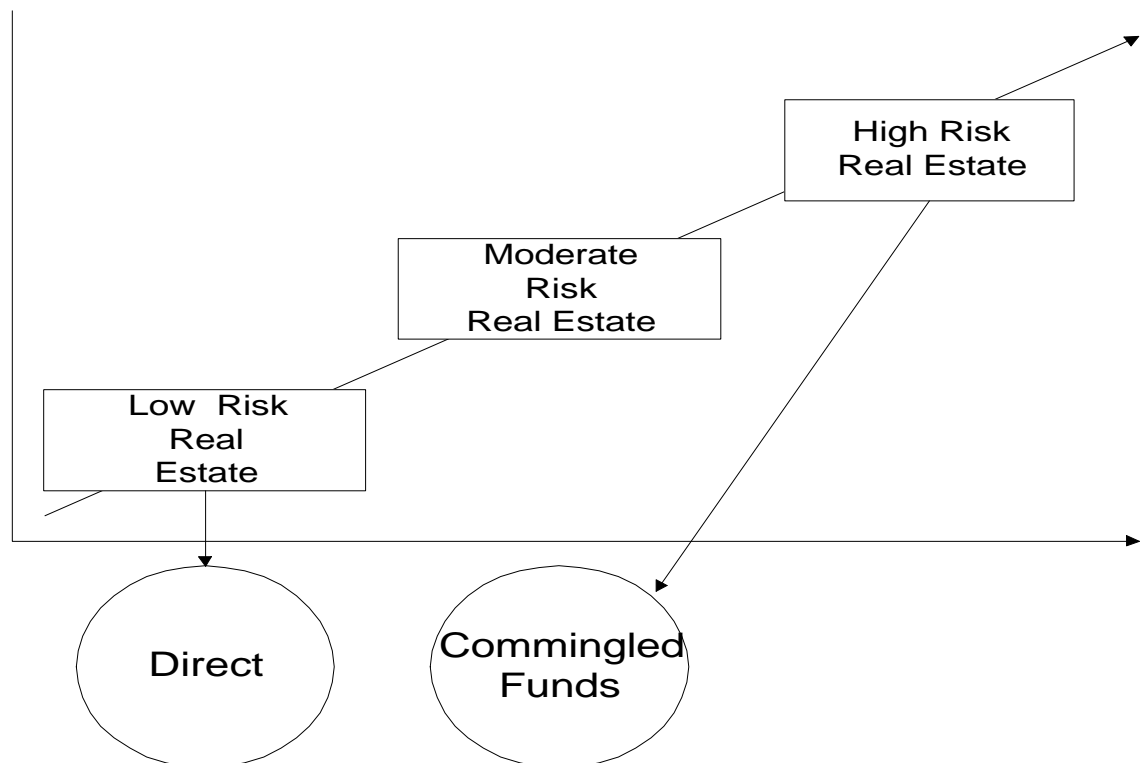
External Advisors and Commingled Funds - All the direct ownership real estate assets are managed by external advisors acting as fiduciaries. These advisors purchase, manage, and sell properties. The following table identifies CalSTRS' current real estate advisors and the estimated December 31, 1998 market value of the portfolios under management.

Lend Lease	\$630 million
CB Richard Ellis	670 million
SSR Realty Advisors(Apartment Only)	179 million
MIG Realty Advisors(Apartment Only)	<u>127 million</u>
 Total Direct Ownership Portfolio	 \$1,606 million

In the commingled fund investment structures CalSTRS is one of several limited partners within a limited partnership. These funds have a broad mandate and can invest in real estate related assets. A portion of each partnership can be invested outside the United States. CalSTRS' opportunistic funds and their current market values as of December 31, 1998 are shown below:

Colony Fund II	\$134 million
Morgan Stanley Fund II	191 million
Lazard Freres Strategic Investors	<u>244 million</u>
 Total Commingled Funds	 \$569 million

Composite Risk/Return profile for the Real Estate Portfolio – The CalSTRS real estate policies identify a strategic target composite risk profile of 75% low to moderate risk assets and 25% moderate to high risk assets. CalSTRS currently holds 73% of its real estate portfolio in low risk direct ownership assets and 27% in high risk commingled funds. The following chart shows CalSTRS' approved composite risk profile and investment structures:



Current Real Estate Policy Summary - The Investment Committee approved the Real Estate Policies at the July 1998 Investment Committee meeting. The following table summarizes CalSTRS' Real Estate Policies:

1. Laws and Statutes	1. Identified and addressed.
2. Role of Real Estate	2. Diversification, yield, and cash flow.
3. Risk Composition	3. 75% low to moderate 25% moderate to high.
4. Cash Flow	4. Meet or exceed the actuarial rate over 5 yr
5. Property Type	5. Industrial, Office, Retail, Apartments, Land, Single Family, Natural Resources.
6. Geographic Location	6. Mid-West, East, South, West and International.
7. Investment Ownership Structure	7. Direct, Commingled Funds, Public Securities.
8. Diversification Guidelines	8. Shown as Exhibit #2 in the Real Estate Policies.
9. Investment Limitations	9. Varied levels of dollar amounts that an individual can invest.
10. Discretionary Authority	10. \$100 million delegation to Staff.
11. Authorized Signers	11. Notification of signer and/or changes.
12. Policy Reporting	12. Real Estate consultant monitors and reports policy to the Board.
13. Performance Benchmark	13. Use NCREIF Property Index to benchmark real estate portfolio.
14. Annual Business Plan	14. Presented in May 1999.
15. Portfolio Reporting	15. PCA to report on a semi-annual basis.

Performance and Benchmark - The current performance benchmark for CalSTRS' real estate portfolio is the NCREIF Property Index. The following table compares the returns of CalSTRS' real estate portfolio with the NCREIF Property Index over the past one, three and five year period and since inception period (1983).

CalSTRS' Real Estate versus NCREIF Index				
December 31, 1987 through December 31, 1998				
	One Year	Three Years	Five Years	Since Inception
STRS Real Estate	21.1%	10.9%	5.5%	5.4%
NCREIF Index	16.1%	10.3%	6.4%	6.7%

LOW RISK REAL ESTATE INVESTMENT STRATEGY

The low risk component of the CalSTRS real estate portfolio was established by Investment Committee approval of the Real Estate Policies. The policy for low risk investing incorporated a diversification strategy by property type and geographic region. Current CalSTRS' risk allocation policy identifies a strategic target of 75% of the real estate portfolio to be invested in low to moderate risk and 25% in moderate to high risk. This business plan redefines the strategic risk into separate categories for low, moderate and high risk. Under the low risk category, Staff proposes a strategic target of 50% with a range of 40% to 75% of the total real estate assets. PCA has determined that this reclassification of risk categories will not affect the overall risk profile of the real estate portfolio currently identified in the Real Estate Policies.

Low risk real estate is defined as:

1. Expected real rate of return of up to 6% (after inflation)
2. Traditional property types (industrial, office, retail and apartments)
3. Substantially leased at acquisition (higher than 90% leased)
4. No leverage on the property
5. Cash flow from property is the largest component of return
6. Properties located in large and diverse geographic areas in the U.S.

Investment structure for public pension funds consist of direct ownership, commingled funds, and public securities. CalSTRS primary investment structure for owning low risk real estate has historically been direct ownership. The primary advantages of direct ownership of low risk assets compared to commingled funds or public securities is the control of the fee structure, dedicated personnel, and geographical diversification.

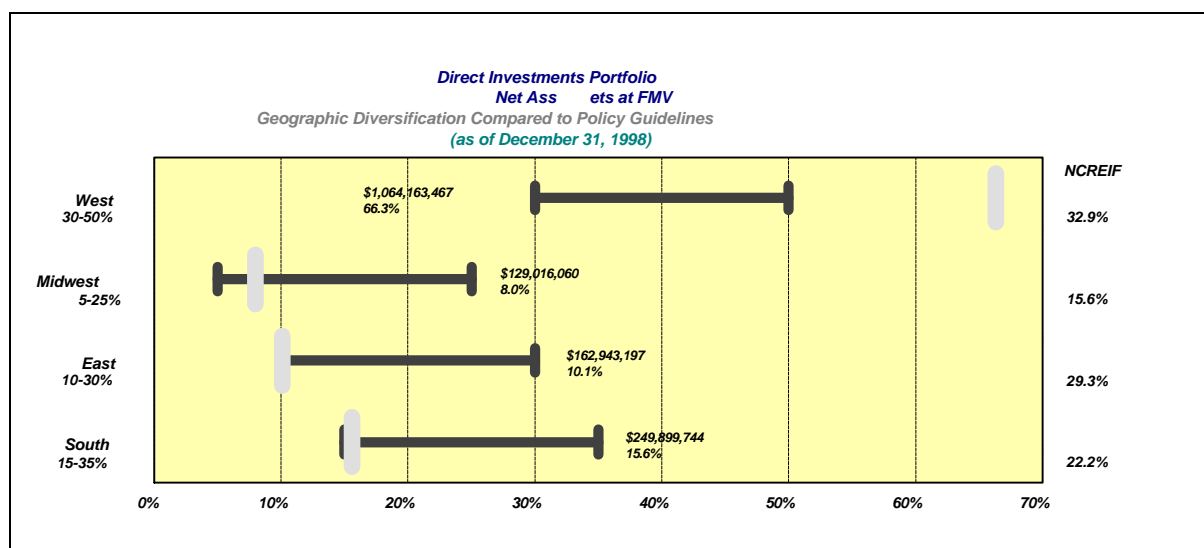
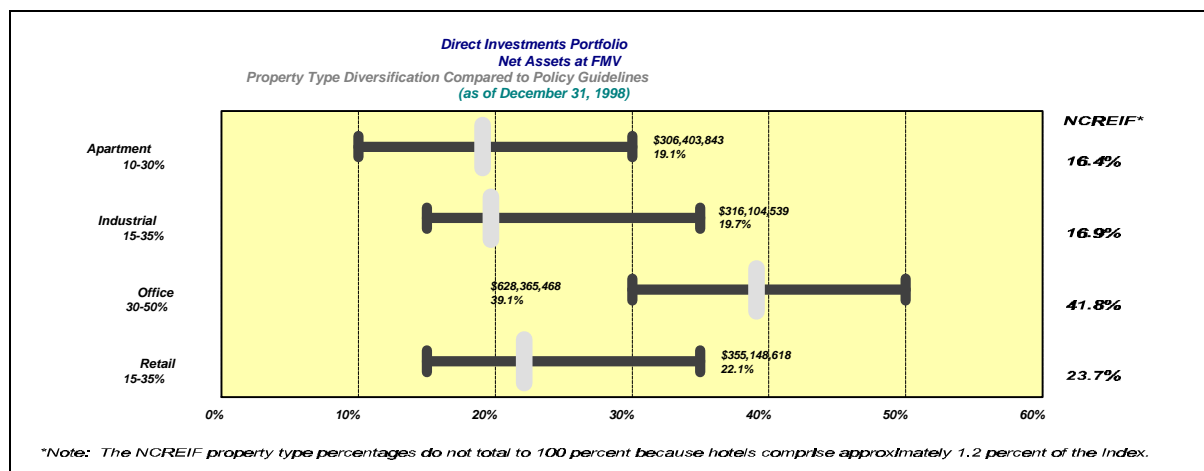
Benchmarking the performance of low risk real estate assets is accomplished through the use of the NCREIF property index. This index has been a proxy for low risk institutional real estate since 1979. The NCREIF property index consists of 2600 properties with a market value of over \$64 billion. The property type composition is primarily office, industrial, retail and apartments. The CalSTRS low risk investment strategy generally reflects the NCREIF regional weighting and product type concentration, thus enhancing the ability to monitor this low risk program and manager performance.

Allocation targets - Given an allocation to real estate of 5% of the total fund, a 50% target allocation for low risk real estate would be approximately \$2.5 billion. Currently CalSTRS has \$1.6 billion in low risk assets. Approximately \$1 billion (net of sales and transfers) of low risk assets would need to be acquired over the next 3 to 5 year period to meet the proposed allocation.

Manager discretion – At the September 1998 Board meeting, the Investment Committee approved the RFP to hire managers that would have “discretion in a box” to purchase, manage and sell direct low risk real estate assets. Exhibit D is the Investment Committee

presentation by PCA on discretion. This exhibit identifies generic examples of “discretion in a box”.

Low risk diversification criteria and strategy - The CalSTRS Policy currently defines two diversification criteria for direct ownership of low risk real estate. These two criteria are geographical location and property type. The following two charts reflect the approved ranges for low risk real estate assets. The grey bar represents CalSTRS’ portfolio composition of low risk assets relative to the ranges. Under the low risk strategy, Staff will allocate discretionary funds to advisors to keep the low risk portfolio within the approved ranges outlined below. A near term objective is to bring the Western region within the geographical range by emphasizing purchasing in other regions or selling at the appropriate time in the Western region. Another secondary objective to rebalance the low risk portfolio would be to reallocate a select group of low risk assets to the moderate risk category by adding leverage.



Implementation Strategy for Low Risk

- Finalize contracts with new and existing managers.
- Complete individual discretionary mandates for each manager (example in Exhibit F).
- Bring the low risk portfolio within the diversification ranges identified in the real estate policy by purchasing, selling, or restructuring properties.

The following chart identifies the overall investment relationship for the low risk investment strategy, identifying investment structure, managers, risk/return allocation and target investment allocation.

(Graphic not available on electronic format.)

Low Risk Managers

CB Richard Ellis
Lend Lease
SSR Realty Advisors
MIG Realty Advisors
Thomas Development *
Lowe *
Sentinel *
Clarion *
Heitman *

* Designates newly selected managers

MODERATE RISK REAL ESTATE INVESTMENT STRATEGY

The moderate risk component of the CalSTRS real estate portfolio was established by Investment Committee approval of the Real Estate Policies. CalSTRS' current risk allocation policy identifies 75% of the real estate portfolio to be invested in low to moderate risk and 25% in moderate to high risk. This business plan redefines separate categories for low, moderate and high risk. Under the moderate risk category, Staff proposes a strategic target allocation of 25% with a range of 10% to 30% of the total real estate assets. PCA has determined that this reclassification of risk categories will not affect the overall risk profile of the real estate portfolio already approved in the Real Estate Policies.

The policy change for moderate risk investing will not incorporate a diversification strategy by property type or geographic region like the low risk strategy. A moderate risk strategy may be more tactical with shorter holding periods allowing for property types and locations to be underweighted or overweighted for limited periods of time.

Moderate risk real estate is defined as:

1. Expected real rates of return between 6% to 12% (after inflation)
2. Traditional and non traditional property types (includes timber, hotels)
3. Partially leased at acquisition (higher than 50%)
4. Moderate leverage (up to 60% loan to value)
5. Cash flow and appreciation are both large components of future value
6. Geographically concentrated within the U.S.

Investment structure for the moderate risk component will consist of direct ownership and commingled funds. Moderate risk real estate can be more tactical in nature than low risk real estate which may require specific expertise and experience from managers. One advantage of direct ownership of moderate risk assets over commingled funds or public securities is the control of the fee structure and dedicated personnel. However, the commingled fund structure allows Staff to utilize, through a limited partnership structure, very specific strategies and companies that would be difficult to replicate through direct ownership.

Benchmarking the performance of moderate risk real estate assets has not been formally established by the pension industry. Since moderate risk assets have a higher risk/return expectation than low risk assets, Staff is proposing that it use the NCREIF property index plus 200 basis points for the benchmark.

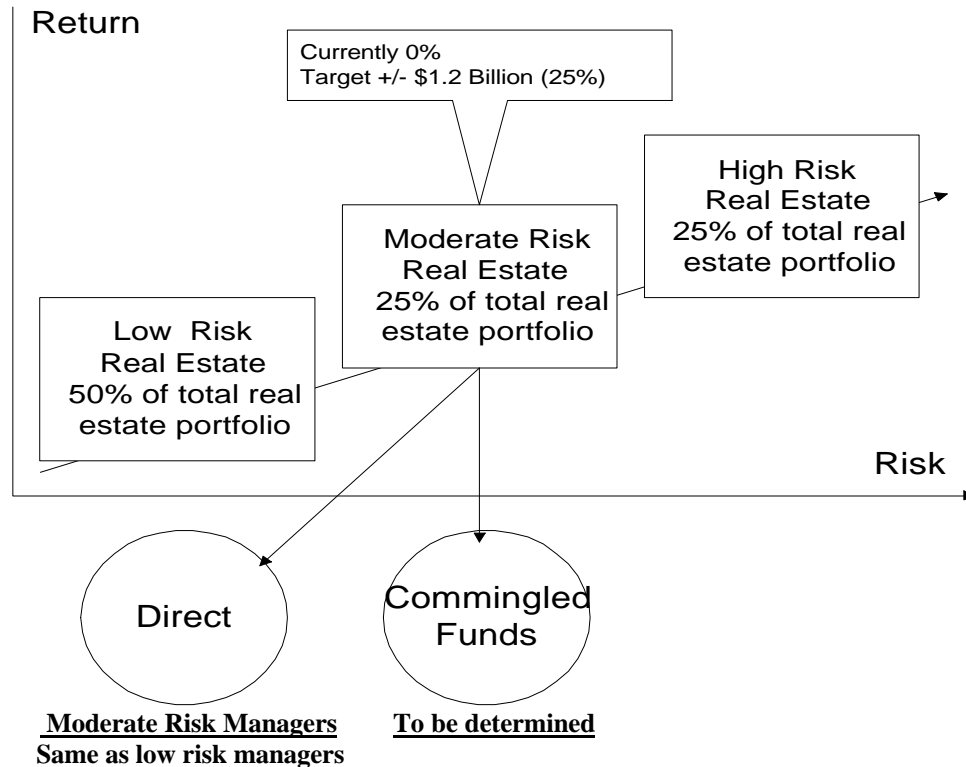
Allocation targets - Given an allocation to real estate of 5% of the total fund, a 25% strategic target allocation for moderate risk real estate would be approximately \$1.25 billion. Currently CalSTRS has no moderate risk assets. Approximately \$1.25 billion (net of sales and transfers) of low risk assets would be acquired over the next 3 to 5-year period to meet the proposed allocation.

Leverage for moderate risk real estate assets is incorporated in the definition for moderate risk real estate investing. As part of fully implementing the moderate risk investment strategy, leverage guidelines will be refined and included in the real estate procedures.

Implementation Strategy for Moderate Risk

- Finalize contracts with new and existing managers.
- Establish leverage guidelines for new financing.
- Monitor managers' performance based on NCREIF sub region and product type plus 200 basis points.
- Evaluate moderate risk commingled funds.

The following graph identifies the overall investment relationship for the moderate risk investment strategy, identifying investment structure, managers, risk/return allocation and target investment allocation. The same managers identified under the low risk strategy will also purchase direct moderate risk real estate assets on a non-discretionary basis.



HIGH RISK REAL ESTATE INVESTMENT STRATEGY

The high risk component of the CalSTRS real estate portfolio was established by Investment Committee approval of the Real Estate Policies. CalSTRS' current risk allocation policy identifies 75% of the real estate portfolio to be invested in low to moderate risk and 25% in moderate to high risk. This business plan redefines separate categories for low, moderate and high risk. Under the high risk category, Staff proposes to continue the strategic target allocation of 25% with a range of 10% to 30% of the total real estate assets. PCA has determined that this reclassification of risk categories will not effect the overall risk profile of the real estate portfolio already approved in the currently approved real estate policies.

The policy change for high risk investing will not incorporate a diversification strategy by property type or geographic region like the low risk strategy. A high risk strategy will be more tactical with shorter holding periods allowing for concentration in selected property types and locations.

High risk real estate is defined as:

1. Expected real rate of return higher than 12% (after inflation)
2. Non traditional property types (includes mini-storage, senior housing)
3. Vacant or construction related (includes new development and redevelopment)
4. Moderate to high leverage (between 50% to 90% loan to value)
5. Appreciation is the largest component of future value
6. Geographically concentrated; potentially international locations

Investment structure for the high risk component will consist of direct ownership and commingled funds. CalSTRS currently owns high risk real estate assets in only the commingled fund investment structure. High risk real estate is more tactical in nature than low risk real estate requiring specific expertise and experience from managers. One advantage of direct ownership of high risk assets over commingled funds or public securities is the control of the fee structure and dedicated personnel. The commingled fund structure allows Staff to utilize, through a limited partnership structure, very specific strategies and companies that would be difficult to replicate through direct ownership.

Benchmarking the performance of high risk real estate assets has not been formally established by the pension industry. Given that high risk assets have a higher risk/return expectation than low and moderate risk assets, Staff is proposing that it use the overall NCREIF property index plus 500 basis points.

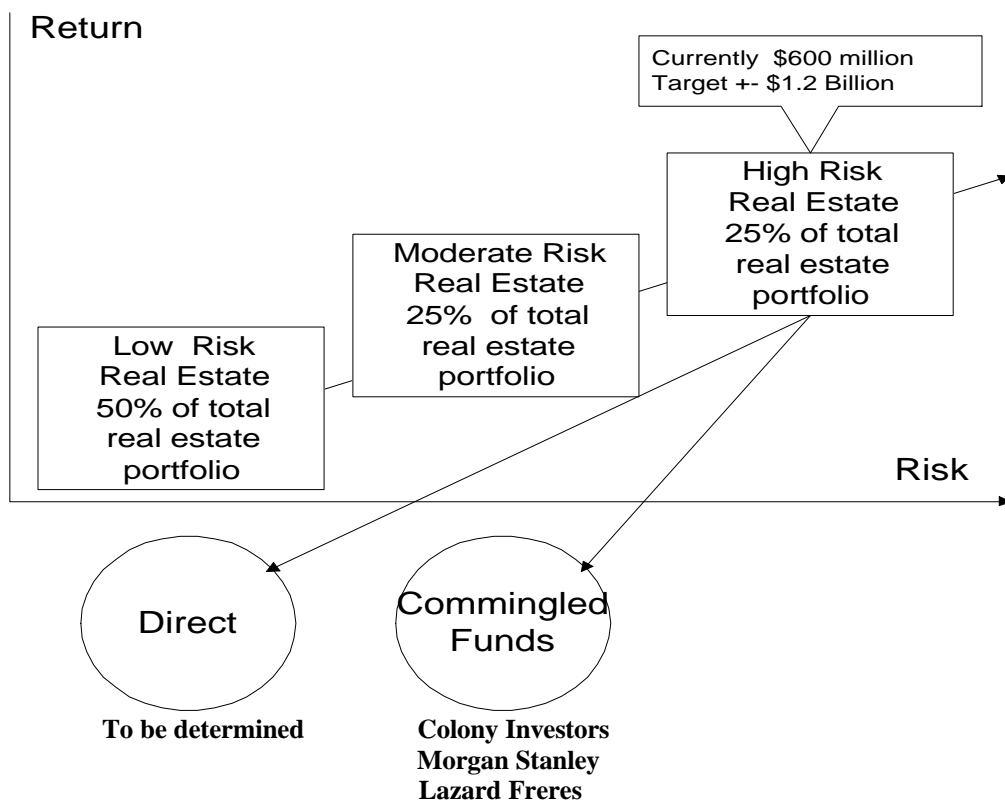
Allocation targets - Given an allocation to real estate of 5% of the total fund, a 25% target allocation for high risk real estate would be approximately \$1.25 billion. Currently CalSTRS has \$600 million invested in high risk assets. Approximately \$600 million (net of sales, distributions and reallocations) of high risk assets would be acquired over the next 3 to 5 year period to meet the proposed allocation.

Leverage for high risk real estate assets is incorporated in the definition for high risk real estate investing. As part of fully implementing the high risk investment strategy, leverage guidelines will be refined and included in the real estate procedures.

Implementation Strategy for High Risk

- Establish leverage guidelines for new financing.
- Evaluate new high risk commingled funds.
- Monitor investment performance based on the overall NCREIF property index plus 500 basis points.
- Establish specific programs, for Investment Committee approval, for direct high risk investments.

The following graph identifies the overall investment relationship for the high risk investment strategy, identifying investment structure, risk/return allocation and target investment allocation.



OVERALL IMPLEMENTATION OBJECTIVES

Continue investing toward strategic allocation targets – The following chart identifies proposed strategic allocation targets for each of the risk categories for the next three-year period.

<u>Risk Category</u>	<u>Current Allocation</u>	<u>Target Allocation</u>	<u>Allocation Differential</u>	<u>Annual Funding</u>	<u>Avg.</u>
Low Risk	\$1.6 Billion	\$2.5 Billion	\$900 Million	\$300 Million	
Mod. Risk	0	\$1.25 Billion	\$1.25 Billion	\$400 Million	
High Risk	\$600 million	\$1.25 Billion	\$650 Million	\$200 Million	
Total Portfolio	\$2.2 Billion	\$5 Billion	\$2.8 Billion	\$900 Million	

Establish New Investment Programs – The following programs will be evaluated during the course of the year and maybe brought before the Investment Committee for approval:

- Multi-family development and rehabilitation
- Single family residential development
- Urban redevelopment
- Commingled Funds weighted specifically toward California investing
- Explore the use of REIT's in the real estate portfolio

Staffing - The inclusion of multiple types of moderate risk and high risk investments may necessitate two additional Investment Officers and one Assistant Investment Officer. The timing of the positions will be dependent on the implementation of programs. One Investment Officer position will be associated with the creation of an in state program for single family and multi-family housing. One Investment Officer position will be primarily associated with the implementation of a moderate risk (adding leverage, leasing risk, etc.) strategy in addition to selecting and monitoring opportunistic types of commingled funds. The Assistant Investment Officer will be primarily responsible with maintaining and updating the on-line data system.

DEFINITIONS and DESCRIPTIONS OF REAL ESTATE TERMS

Advisor – A company which, by contractual agreement, provides property investment opportunities and/or property asset management services.

Appraisal – An estimate or opinion of market value.

Appreciation – The percentage change in the market value of a property or portfolio over the period of analysis.

Asset Management – The various disciplines involved with managing real property assets from the time of investment through the time of disposition. Proper asset management plans and policies include requirements for operating and capital budgets; property management; leasing; physical property analysis; operational and financial reporting; appraisal; audits; accounting policies; and asset disposition plans (hold/sell analyses).

Benchmark – An index derived from database information which allows for comparative performance evaluation within an asset class.

Capital Improvements – Expenditures that cure or arrest deterioration of property or add new improvements to prolong its life.

Co-investment – Investments where the management organization has a capital investment and ownership share.

Commingled Fund – A term applied to all open-end and closed-end pooled investment vehicles designed for institutional tax-exempt investors. A commingled fund may be organized as a group trust, partnership, corporation, insurance company separate account, private real estate investment trust or other multiple ownership entity.

- ◆ **Open-end Fund** – A commingled fund with no finite life, that allows continuous entry and exit of investors, and typically engages in ongoing investment purchases and sale activities.
- ◆ **Closed-end Fund** – A commingled fund with a stated termination date, with few or no additional investors after the initial formation of the fund. Closed-end funds typically purchase a portfolio of properties to hold for the duration of the fund and, as sales occur, typically do not reinvest the sales proceeds.

Discretion – The level of authority given to an advisor over the investment and management of a client's capital once that capital is allocated to the advisor.

Direct Investment – An investment in which CalSTRS has a direct ownership interest in a property or group of properties.

Fair Market Value – The highest price a property would bring if exposed for sale in the open market by a willing seller to a willing buyer with both parties being fully informed of all the uses and purposes to which the property is reasonably adaptable and available.

Ground Lease – A lease of land only, not including any improvements on the property.

Income – The component of return derived from property or portfolio operations during the period of analysis.

Internal Rate of Return (IRR) – The actual (or projected) dollar-weighted holding period return produced by an asset, calculated with consideration for all items of cash in and cash out.

Joint Venture – An investment structure wherein differing and often disproportionate ownership interests are acquired by the individual venture partners.

Limited Partnership – A partnership with both general and limited partners in which the general partner manages the business and assumes full liability for the partnership obligations with the liability of the limited partners generally restricted to their capital contributions.

NCREIF Index – National Council of Real Estate Investment Fiduciaries Index; a property-level performance benchmark for institutionally owned real estate, calculated on a quarterly basis.

Net Operating Income – Rental and other income of a property, less operating expenses but before the deduction of capital expenditures and debt service.

Opportunistic – A phrase characterizing investment in underperforming and/or undermanaged assets typically purchased from distressed sellers; utilizing high levels of leverage with the expectation of near-term increases in cash flow and value.

Property Management – The various functions that are performed at the property level in order to assure timely collection of rents, payment of expenses and supervision of on-site activities.

Real Rate of Return – Yield to the investor after adjusting for inflation (typically determined by the Consumer Price Index).

Total Return – The sum of the income and appreciation returns.

Value-Added – A phrase commonly used by advisors to describe a management approach to a property with the connotation that their skills will add value which otherwise would not be realized.

THE ROLE OF REAL ESTATE

Background

During a series of asset allocation workshops presented in 1997, the Investment Committee, assisted by Pension Consulting Alliance (PCA), reviewed STRS' overall asset allocation. At the Investment Committee's direction, PCA developed a set of constraints within which to model the various asset classes. The result of this process was to create an efficient frontier with expected risks and returns that were designed to meet the STRS' actuarial and financial goals.

The asset allocation policy, adopted in June 1997, included a 5% allocation to real estate as indicated in the table below:

Asset Class	6/30/95 Policy	6/30/97 Policy
Alt. Investments	3%	5%
Int'l Stocks/Emerging Mkts	18%	25%
Domestic Stocks	34%	38%
Real Estate	5%	5%
Global TAA	5%	0%
Global Fixed income	0%	26%
Fixed Income	34%	0%
Cash	1%	1%

In July 1997, the Investment Committee adopted the 1997/98 Investment Branch objectives. One of the objectives for the Real Estate Area was to develop the appropriate risk and liquidity composition of the real estate portfolio considering traditional, opportunistic and securitized components. A timeline and action plan for completing this objective was presented and approved. The first aspect was the selection of a real estate consultant. Pension Consulting Alliance/E&Y Kenneth Leventhal (PCA/EYKL) was selected in January 1998 to provide real estate consulting services to CalSTRS to assist in the identification and presentation of the role of real estate in the investment portfolio.

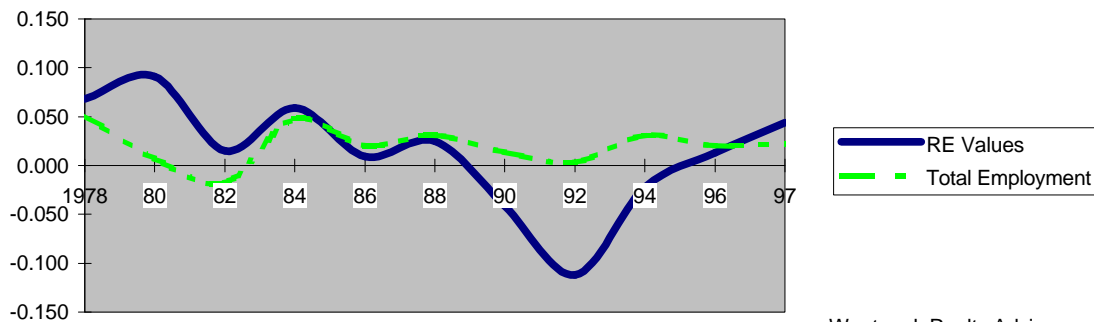
Real Estate Overview

Financial institutions began investing in real estate in the late 1970s, stimulated by real estate's attractive returns during the previous ten year period and the emphasis given to diversification with the implementation of ERISA. Today, financial institutions (i.e. banks, savings & loans, insurance companies and pension funds) continue to seek the positive characteristics of investment real estate for their portfolios. Investment real estate has stable cash flow, low correlation with other investments, and potential higher returns. These characteristics have made investment real estate attractive to financial institutions as an asset class since the late 1970s.

Investment real estate within the pension fund industry has been subject to price volatility or cyclical changes in value like other asset classes. During the late 1980's, the pension fund industry invested large amounts of capital into investment real estate. Later changes in the supply of capital, changes in tax laws, and changes in economic activity in the United States created a supply/demand imbalance which had a negative effect on real estate values countrywide.

Investment real estate values are also subject to various local and regional pressures. Primary factors effecting investment real estate are regional employment growth and local market supply/demand equilibrium. The following table shows the correlation between employment growth and real estate values.

Change in Real Estate Values (NCREIF) vs. Change in Total U.S. Employment



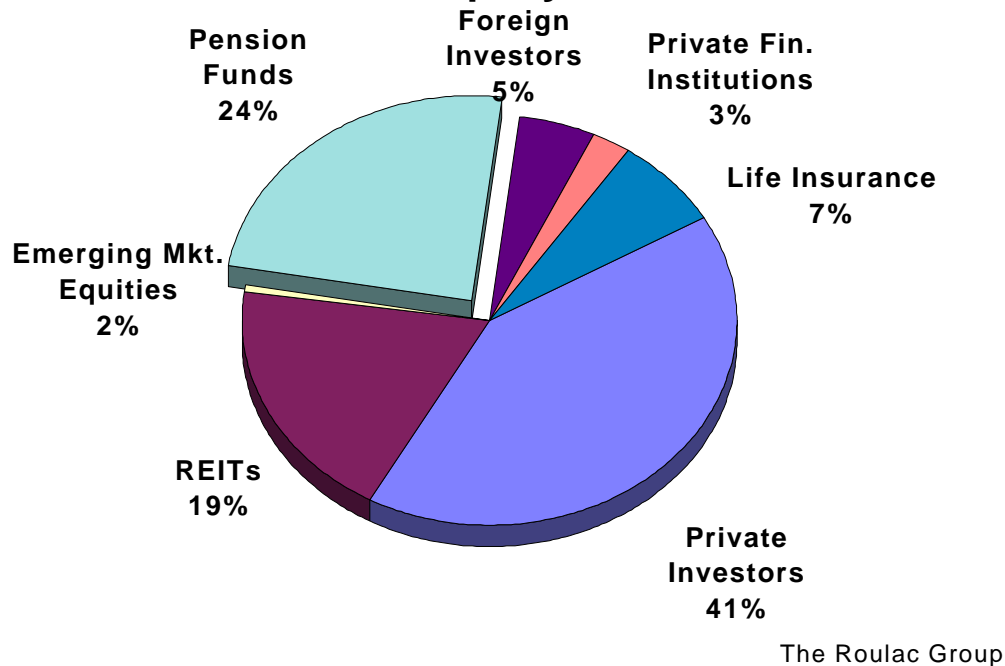
Westmark Realty Advisors

Size Of The Investable Real Estate Market

Real estate comprises an estimated 54% of global wealth. In the United States, it is estimated that real estate represents 45% of all assets. Approximately, 50% of real estate assets are private residential, 25% are Government non-residential, and the remainder is private non-residential. It is predominately the private non-residential sector that financial institutions utilize for their real estate investments.

Lend Lease research estimates that the potential investable U.S. real estate market is \$3.2 trillion. The current ownership of the United States investable real estate equity market is estimated at \$572 Billion. The largest components of this market are private investors (41%) and pension funds (24%). The following graph identifies the real estate equity owners as of December 1997.

Real Estate Equity Owners 1997



The size of the investable international real estate market is difficult to accurately assess given the various languages, cultures, and currencies. However, an estimated 400 public real estate companies exist in Canada, Asia, and Europe having a total market capitalization of approximately \$215 billion.

Characteristics Of Investment Real Estate

Over the last twenty years, pension funds have accumulated approximately \$138 billion of investment real estate in their portfolios. The risk and return characteristics of investment real estate can differ substantially. Three real estate risk scenarios are identified below:

Low Risk Scenario - Purchase an industrial building with tenant occupancy at 90% and no leverage placed on the property.

Moderate Risk Scenario - Purchase an industrial building with tenant occupancy at 50% and secure a 30% loan.

High Risk Scenario - Purchase industrial land to build an industrial building for resale and secure a 75% loan on the property.

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

Low Risk

- Expected 4%-6% real rate of return
- Traditional property type (industrial, office, apartment and retail)
- Substantially leased properties at acquisition
- No leverage on the property
- Cash flow from property is the largest component of value
- Large and diverse geographic areas

Moderate Risk

- Expected 6%-12% real rate of return
- Some lease-up risk
- Public securities (REIT, real estate company)
- Moderate leverage(20%-60% loan to value)
- Specialized property type (Timber, Hotel)
- Non economically diversified geographic areas

High Risk

- Expected 12%-20% real rate of return
- Land development
- High leverage(75% or higher loan to value)
- Appreciation largest component of value
- Currency or political (international)

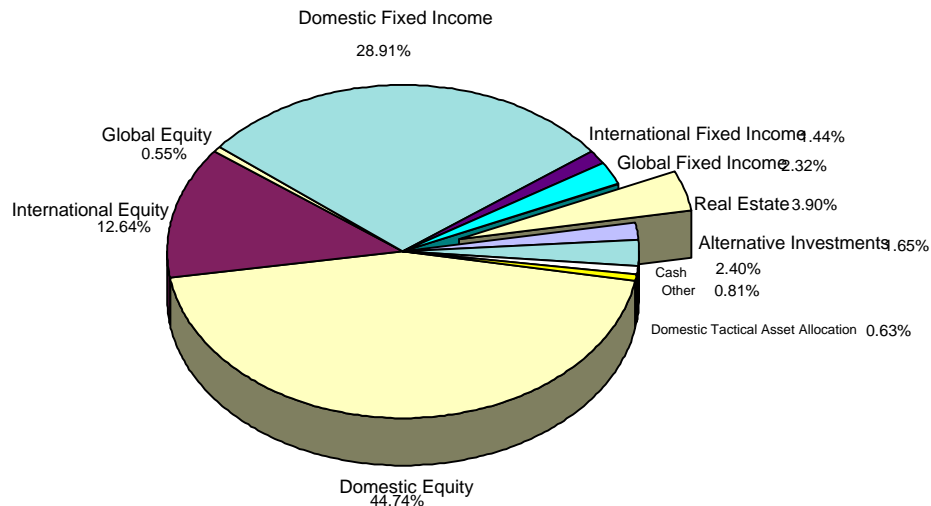
Changing Risk Profile For Real Estate

In the early 1990s, institutional investors began to shift their focus on real estate investing from low risk to moderate or high risk. This shift in risk tolerance was due in part to the early success of the opportunistic funds. Since 1991, a substantial amount of new real estate investments for institutional real estate investors have been in opportunity funds and real estate investment trusts (REIT). The opportunity funds represent high risk/return characteristics for institutional investors and have grown to approximately \$20 billion in committed equity. The REIT market represents, in general, a moderate real estate risk/return profile. The REIT market has increased from \$12 billion in 1992 to nearly \$100 billion in 1997.

Real Estate Allocations For Pension Funds

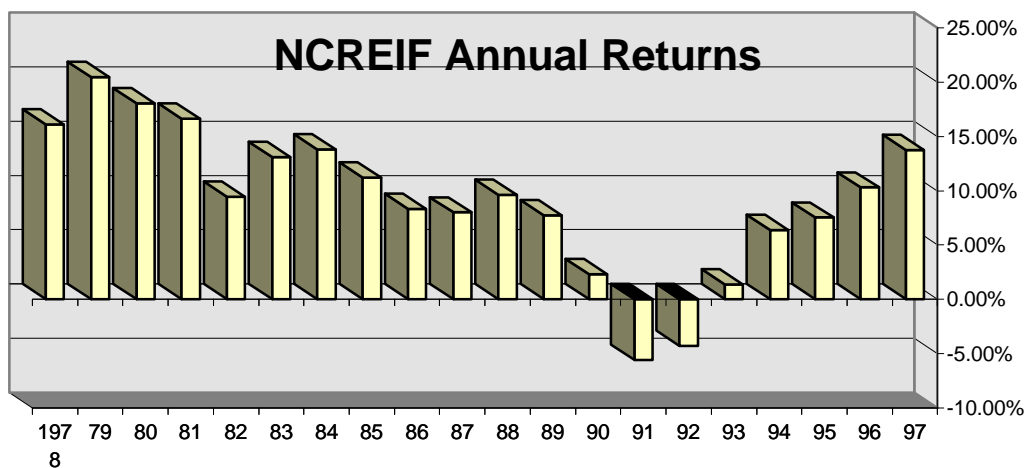
Since the early 1980s pension funds have targeted an allocation to real estate in the 5% to 15% range depending on various investment strategies. Like STRS, most pension funds remain underfunded in real estate in relationship to their asset allocation targets. A recent survey by the Institute of Fiduciary Education (IFE) of public pension funds revealed that 77% of the public funds surveyed have not funded to their stated target. For the 121 public funds surveyed, the average actual amount funded to real estate was 3.9%. Also, 68% of public funds in the IFE Network have included real estate investments in their asset allocation

process. The following chart reflects asset allocation by public pension funds as reported to IFE.



Performance Benchmark and Benchmark Returns

The primary performance benchmark for real estate has been the NCREIF Index. This Index has been a proxy for low risk institutional real state since 1979. The NCREIF Index consists of 2600 properties with a market value of \$60 billion. The property type composition of this Index is primarily office, industrial, retail, and apartment. The following graph shows total composite unleveraged returns for the NCREIF Index since 1979. The NCREIF Index measures the return characteristics of low risk real estate.



The primary benchmark for the public REIT securities market is the NAREIT Index. The NAREIT Index has an approximate market value of \$123 billion. Given the daily pricing of REITs and the correlation with the stock market, this Index has been more volatile than NCREIF Index. The NAREIT Index differs from the NCREIF Index in that it takes into consideration leverage, management company value, growth potential, and stock market volatility.

Currently, there is no industry benchmark for measuring the returns for high risk real estate investments. Given the recent investment activity in opportunity funds to employ high risk strategies, there remains a potential that an index or sample of funds could be established as a measure of performance for high risk real estate investments.

Real Estate Investment Structures

Public pension funds invest and hold real estate in basically three different investment structures. These are **direct ownership, commingled fund, and public securities**. A recent survey by IFE shows that public pension funds hold real estate assets as follows: 64% direct ownership, 21% commingled funds, 7% public securities and 8% in a combination of joint ventures and hybrid structures. The following is a summary of the respective characteristics of the three main investment structures.

Direct Ownership

- Control of buy, sell, and asset management
- Moderate liquidity
- Control of management cost structure
- Generally, fee simple 100% ownership

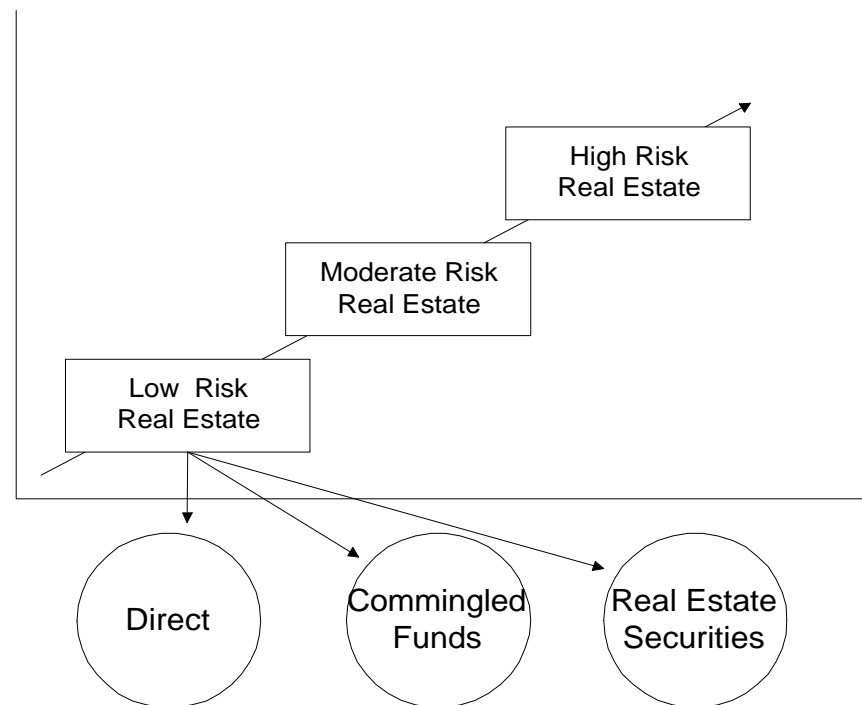
Commingled Fund

- No control of buy, sell, or asset management
- Limited liquidity
- No control of cost structure
- Limited partnership or private securities structure

Public Securities

- Control of the buy and sell
- No control of asset management
- High liquidity in limited amounts
- No control of cost structure
- Stock ownership

During the 1980s pension funds invested in low risk real estate through commingled funds and direct ownership. As pension funds changed their investment strategies in the early 1990s from low risk to moderate or high risk, the primary investment structures were commingled funds and public securities. The following chart illustrates that each investment structure can hold real estate at different risk levels.



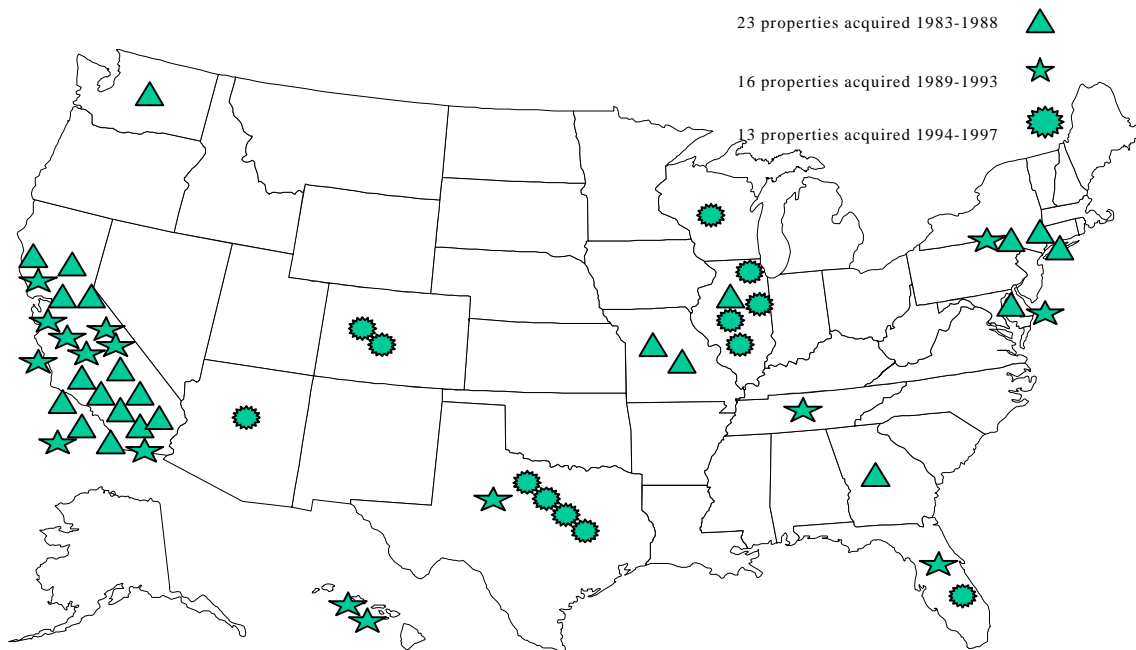
STRS Real Estate Experience (1983-1997)

In 1983, with the implementation of Proposition 21, STRS was permitted to purchase real estate. Three years later, the first set of policies for investing in real estate was presented to the Investment Committee by Institutional Property Consultants (IPC). The primary role for real estate in the STRS portfolio was identified as a diversifier of total fund assets. STRS designed a strategy to establish and maintain a portfolio of office, industrial, and retail properties. The property location, characteristics, and cash flow would be classified as low risk. In 1991, IPC recommended expanding the risk level of the real estate portfolio. IPC recommended five new property types - apartments, timberland, hotels, and commercial land. The Investment Committee adopted one of the proposed property types - apartments. In 1995, IPC recommended expanding the risk level of the real estate portfolio through participation in opportunistic commingled funds. The Investment Committee approved three high risk funds: Colony Investors II, Lazard Freres Strategic Reality, and Morgan Stanley Real Estate Fund II.

STRS Accumulation Of Real Estate

By December 1992, CalSTRS' real estate portfolio had grown to 40 properties across the United States totaling \$2.0 billion of market value. From 1987 to 1992, STRS averaged \$237 million a year in acquisitions of low risk real estate. Over the next five years (1993-98), STRS acquired approximately \$230 million while selling more than \$500 million of low risk real estate. In 1995, STRS committed \$500 million to three opportunistic commingled funds. The net effect of the last five years of purchase and sale activity is that the market value of the real estate portfolio is unchanged (\$1,992 million as of 12/31/92 compared to \$2,003 million as of 12/31/97). The percentage of real estate has been reduced from 4.5% as of 12/31/92 to 2.5% as of 12/31/97 because of the substantial growth in other asset classes during that five year period.

The following map looks at STRS accumulation of real estate assets:



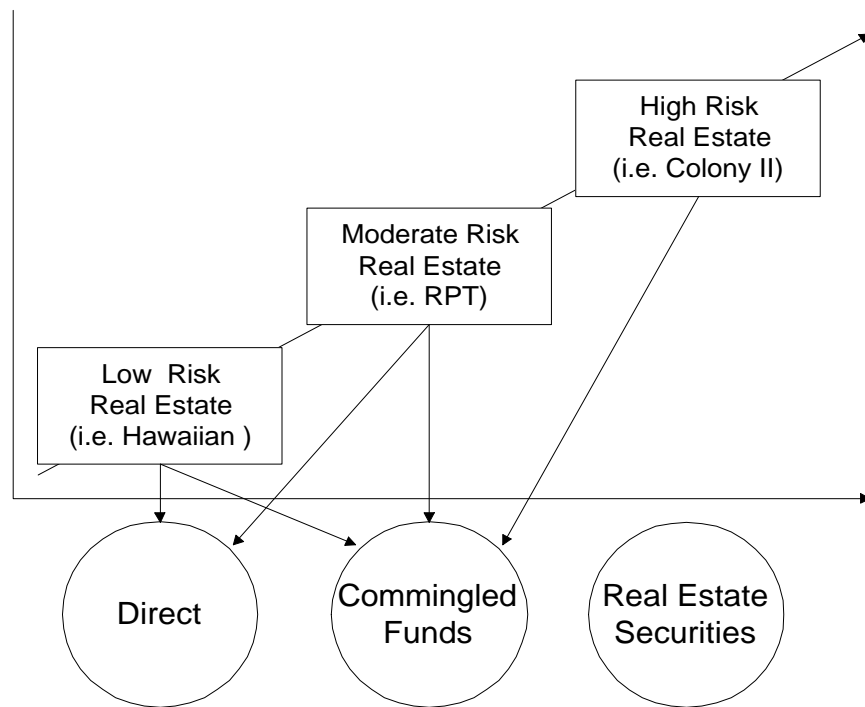
STRS Investment Structures For Real Estate

CalSTRS primary investment structure since the beginning of the real estate program has been direct ownership. STRS currently holds 75% of its real estate portfolio in direct ownership and 25% in commingled funds. Currently, STRS holds no public REIT stocks within the real estate portfolio.

Like the real estate pension fund industry in general, STRS investment structures are not linked solely to accessing specific risk and return strategies. STRS used the commingled fund structure in acquiring:

- (1) Hawaiian Property Fund as a low risk strategy
- (2) Retail Property Trust as a moderate risk strategy
- (3) Colony Investors II as a high risk strategy

The following chart shows what investment structures STRS used to access various levels of risk:



CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

REAL ESTATE POLICY MANUAL

INVESTMENT BRANCH
MAY 1999

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INTRODUCTION

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for investment real estate, an illiquid equity related asset, using internal staff and external specialized professionals. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives to achieve a rate of return which corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the investment portfolio.

Investment real estate can be divided into three broad categories of risk: (1) low risk, (2) moderate risk, and (3) high risk. Each risk category contains certain characteristics which have been included as Exhibit 1. CalSTRS investment real estate portfolio will have a strategic target of 75% low to moderate risk and 25% moderate to high. risk/return allocation of 50% low risk, 25% moderate risk and 25% high risk.

CalSTRS investment real estate portfolio may consist of real estate assets purchased and owned by three main investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

The CalSTRS Board has established the asset allocation and strategic objectives for the real estate portfolio. The purchase, management and sale of all types of real estate investments are performed by external professionals which are monitored and evaluated by internal investment officers and an external real estate consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external real estate consultant reports directly to the CalSTRS Board.

This manual will establish the policies ~~and procedures~~ involved in the management of investment real estate. The policies are designed to set boundaries for expected performance, diversification, and investment structure. ~~The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies and procedures presented.~~

INVESTMENT REAL ESTATE POLICIES

May 1999

The following represent approved policies to be utilized in the management of the California State Teachers Retirement Systems (CalSTRS) investment real estate portfolio. The policies are designed to set boundaries for the expected performance, diversification and investment structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

- 1. Laws and Statutes** - The investment real estate portfolio of the California State Teachers' Retirement System is to be invested, managed and sold in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the investment real estate portfolio.
- 2. Role of Investment Real Estate** - The primary role of the investment real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows. ~~This policy issue was discussed in detail and adopted at the April 1998 Investment Committee meeting.~~
- 3. Portfolio Risk Composite** - CalSTRS has established a composite risk range for the investment real estate portfolio. ~~A target of 75% low to moderate risk and 25% moderate to high risk was approved. This policy issue was discussed in detail and adopted at the April 1998 Investment Committee meeting.~~ A strategic allocation target of 50% in low risk and a range of 40% to 75%, a 25% target for moderate risk with a range of 10% to 25% and a target of 25% for high risk with a range of 10% to 25% will be used. The definition of the different risk levels has been included as Exhibit 1.
- 4. Portfolio Cash Flow** - The projected cash flow for new acquisitions in the low to moderate risk portion of the investment real estate portfolio is expected to ~~meet or exceed~~ approximate the actuarial rate assumption over a five-year horizon. Moderate risk and high-risk investments will not be constrained by cash flow targets and will emphasize yield enhancement over a shorter time frame than low risk investments. Exceptions to this policy will be approved in writing by the Chief Investment Officer.
- 5. Property Type** - The property types used for direct investments in the real estate portfolio are defined as Industrial, Land, Multi-Family Residential, Natural Resources, Office, Retail, Single Family Residential, and other property types as approved in writing by the Chief Investment Officer.

- 6. Geographic Location** - Geographic regions for investing are defined as the location of the individual property. The geographic breakdown is expressed as Mid-West, East, South, West, and International. Properties located outside the United States can be held only in the high risk category.
- 7. Investment Ownership Structure** - CalSTRS can invest and hold real estate assets in the following three investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.
- 8. Diversification Guidelines** - The direct low risk investments contained in the investment real estate portfolio shall have a strategic target and range established for the following diversification criteria: (1) property type and (2) geographic location. The target and range for each criteria are included as Exhibit 2. Purchases or sales shall not be completed for the sole purpose of aligning one specific criteria. Projected rate of return, composite risk profile, and other policies should receive consideration in all transactions. Moderate and high risk investments will not have diversification targets by property type or geographical location.
- 9. Investment Limitations** - Graduated limitations of daily buying and selling cash, securities, and properties for aggregate real estate equity investment portfolio transactions are as follows (including lock box transactions):

Associate Investment Officer	\$ 1 million \$ <u>5 million</u>
Investment Officer I	\$ 5 million \$ <u>10 million</u>
Investment Officer II	\$ 10 million \$ <u>25 million</u>
Investment Officer III	\$ 20 million \$ <u>50 million</u>
Director of Real Estate	\$ 50 million \$ <u>250 million</u>
Chief Investment Officer	\$ 100 million \$ <u>1 billion</u>

- 10. Discretionary Authority** - The rejection and approval decision for low, moderate and high risk direct ownership properties, co-investments, commingled funds and secondary interests is delegated to Staff with the stipulation that all investments are subject to the appropriate due diligence as defined in the real estate procedures.

The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to Staff considering the following stipulations:

- A. Due diligence process shall be consistent and appropriate as defined in the investment real estate procedures.
- B. Maximum amount of the commitment should not exceed \$100 million.
- C. A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.

Staff can delegate the above authority to CalSTRS' real estate managers for the implementation of the low risk investment strategies.

- 11. Authorized Signers** - Authorization letters which indicate who may sign on behalf of CalSTRS shall be delivered to the appropriate parties. Whenever a change in authorized signers(s) occurs, the effected parties shall be notified within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer.
- 12. Policy Reporting** - CalSTRS' real estate consultant shall monitor the investment policies and report to the CalSTRS Board as requested.
- 13. Performance Benchmark** - CalSTRS' shall use the NCREIF Property Index to benchmark ~~low to moderate risk~~ real estate investments in the portfolio.
- 14. Annual Business Plan** - The Real Estate portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
- 15. Portfolio Reporting** - The real estate consultant will prepare and present a portfolio management report on a semi-annual basis. The management report will evaluate CalSTRS' property and regional diversification and property and partnership performance.

Adopted on June 3, 1998

Amended on_____

Investment Real Estate Policies

Definition of Risk Characteristics for Real Estate

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

Low Risk

- Expected real rate of return of up to 6% (after inflation)
- Traditional property types (industrial, office, retail and apartments)
- Substantially leased at acquisition (higher than 90% leased)
- No leverage on the property
- Cash flow from property is the largest component of return
- Properties located in large and diverse geographic areas in the U.S.

Moderate Risk

- Expected real rates of return between 6% to 12% (after inflation)
- Traditional and non traditional property types (includes timber, hotels)
- Partially leased at acquisition (higher than 50%)
- Moderate leverage (up to 60% loan to value)
- Cash flow and appreciation are both large components of future value
- Geographically concentrated within the U.S.

High Risk

- Expected real rate of return higher than 12% (after inflation)
- Non traditional property types (includes mini-storage, senior housing)
- Can be vacant or construction related (includes new development and redevelopment)
- Moderate to high leverage (between 50% to 90% loan to value)
- Appreciation is the largest component of future value
- Geographically concentrated; potentially international locations

**Investment Real Estate Policies
Diversification Criteria for the Direct Portfolio**

Geographical Location	Range	Target	12/31/98 Actual
• West	30% - 50%	40%	66%
• South	15% - 35%	25%	16%
• East	10% - 30%	20%	10%
• Mid-West	5% - 25%	15%	8%
• International	0% - 10%	0%	0%

Property Type	Range	Target	12/31/98 Actual
• Industrial	15% - 35%	25%	20%
• Apartments	10% - 30%	20%	19%
• Office	30% - 50%	35%	39%
• Retail	15% - 35%	20%	22%
• Other *	0% - 10%	0%	0%

* Other to include Land, Single Family Residential, Natural Resources and Hotels

Exhibit D insert

(Graphic not available on electronic format.)

**Current Real Estate Investment Environment
March 1999**

Market Conditions

- Real estate market conditions continue to be very healthy.
- NCREIF benchmark returns highest since early 1980s.
- Positive real estate fundamentals:
 - Vacancy rates currently averaging below 10% in most markets.
 - Supply and demand in equilibrium.
 - Credit crunch in late 1998 slowed both acquisition and development activity, reducing concerns of overheating and oversupply.
- Healthy US economy, but rate of growth is slowing.

Outlook by Property Sector

- Industrial sector fundamentals healthiest of all property types.
- Office sector expected to produce robust returns provided modest US economic growth continues.
- Apartment properties holding value despite significant recent development activity.
- Retail sector experiencing structural changes. Dominant regional malls and neighborhood/community shopping centers should perform well. Middle tier malls suffering. Impact of internet shopping alternatives is unclear.
- Prospects for hotel sector generally unfavorable due to oversupply and tourism decline.

Capital Markets Activity

- Supply of and demand for real estate transactions generally in balance:
 - Few sellers forced to liquidate positions.
 - Most investors less leveraged than in past.
 - Transactions structured to meet both buyer and seller objectives.
- Lenders are more conservative and selective with generally lower loan-to-value ratios.
- Pension funds active in both low and high risk investments.

- REITs seeking off-balance sheet capital for growth; consolidations and going private are becoming more common.
- Opportunity funds active, but investment pace has slowed due to uncertainty regarding market values, concerns with existing portfolios and increased bid/ask spreads between buyers and sellers.

Investment Opportunities and Expectations

- Take advantage of REITs' lack of investment capital.
- Evaluate possible joint venture development projects.
- Reduce overall unleveraged return expectations to historical levels of 9% - 10%.
- Rental growth for all property types is expected to slow.
- Rising prices will lead to new construction.
- Increased securitization in real estate and mortgages will benefit private market investors in terms of decreasing the severity of the swings in the cycle and therefore reducing volatility.

RESOLUTION OF THE
CALIFORNIA TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Real Estate Policy

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Real Estate Policies and has heard oral presentations from Staff and Pension Consulting Alliance (PCA); and

WHEREAS, the Staff has recommended the adoption of the Real Estate Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Real Estate Policies.

Adopted by:

Investment Committee
on _____

James D. Mosman
Chief Executive Officer